Business Standard

What is your risk profile?

It is a question that depends on various factors, such as age, dependents and market conditions

Tinesh Bhasin | Mumbai July 10, 2016 Last Updated at 21:48 IST

IIFL Wealth

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Management is looking at innovative ways to improve investors' risk profiling method. "Our current technique follows the best global practices but as financial markets are increasingly becoming unpredictable, we need better understanding of investors' behaviour," says Somnath Mukherjee, senior partner.

The company aims to capture a client's behaviour when markets are volatile or when an event like the global financial crisis of 2008 wipe out wealth. Among many ideas is exploring, one is of capturing the number of times a client checks his portfolio returns. "Those checking more often are likely to get affected by market movements easily," says Mukherjee.

Risk profiling is the foundation of a financial plan. The more accurately an advisor assesses; he is able to recommend more suitable products and the right asset allocation.

Psychometric risk profiling

As a first step, wealth managers use psychometric tests to assess the risk profile of an individual. These tests have questions that ask the respondents what they will do in certain market conditions.

MOST COMMON QUESTIONS

- Over one-year period, what is the biggest drop in value of your investment portfolio that you would be comfortable with?
- How long would you be willing to wait for your investment to regain any lost value?
- While making a long-term investment, how long do you plan to keep it?

Many say this has limitations. "Such tests capture the prevailing state of mind of an investor," says Rajesh Iyer, head, investment advisory services and family office at Kotak Wealth Management. While taking the test, if the person has been making money by investing in risky assets, he will give answers that will classify him as an aggressive investor. If the same person has lost money recently, his answer would end up classifying him as a conservative investor.

Different approaches

While a few wealth managers rely on only psychometric tests, most use it as a starting point. They use different approaches to fine-tune the test result. "Risk profiling requires much more effort than only going by the outcome of questions. More accurate profiling is only possible after engaging with clients in lengthy discussions," says Shankar Raman, chief investment officer (CIO), Centrum Wealth Management. He says risk profiling is a continual process. Kotak Wealth Management, has a similar approach and it reviews risk profile once a year. IIFL Wealth Management sticks to the outcome of its proprietary test, as it avoids human intervention.

Financial planners such as Vishal Dhawan, founder and Chief Executive Officer (CEO) of Plan Ahead Wealth Advisors, does risk profiling using software and then engaging with clients. Based on his assessment, he presents clients with different risk- and- return scenarios and goes by the one the investor prefers. Suresh Sadagopan, founder of Ladder Financial Advisories, sticks to the risk profile generated by a software. There are robo advisory firms that do not come face-to-face with investors.

ArthaYantra uses behavioural finance-based test. "The questions try to assess how people behave with money with respect to situations. We combine this with the amount of risk a person can take in his present situation," says Nitin Vyakaranam, CEO and founder of ArthaYantra. Dinesh Rohira, founder CEO, 5nance.com, says they use psychometric tests for risk profiling.

Do it yourself

Most believe the current methods are not foolproof. Wealth managers, however, agree on one thing: The individual is the best judge of his own risk profile as he gains more investing experience. A Do-it-Yourself investor can adopt similar approach to investment advisors and start with an investment questionnaire.

"When someone is doing his own risk profiling, possible methods can be to look at the worst returns on the investments done with reasonably high confidence - that will help to understand the risk. Other simple way to do it is to look at the volatility of various instruments and then measure the risk adjusted returns," says Iyer.

Mukherjee says that investors should look at three things. One, comfort with volatility in market. Two, does lack of liquidity in certain investments bother them - like in long-term bonds. Three, how much 'drawdown' can they bear. That is, if the portfolio sees a 20 per cent correction will they be willing to pump in more money or prefer to exit.